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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

REPLY COMMENTS OF
THE UNITED STATES TELEPHONE ASSOCIATION

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SUMMARY

Many non-LEC parties argue for changes in the LEC price cap plan which would substantially diminish incentives that are necessary to achieve important Commission goals in the Information Age. Their proposals would also make it more difficult to transition price cap regulation to a more competitive industry environment. As demonstrated herein, the positions of these non-LEC parties do not stand scrutiny and should be rejected.

Non-LEC parties generally argue for retention of the sharing mechanism and several, notably Ad Hoc, AT&T and MCI, urge the Commission to recalibrate the sharing mechanism to a lower rate of return. As USTA made clear in its comments, however, sharing, the low end adjustment mechanism and other vestiges of rate of return regulation have no place in an incentive regulation plan and should be eliminated from LEC price caps. Moreover, arguments that the price cap sharing thresholds and indices should be adjusted downward are entirely without merit. LEC earnings under price caps have been, if anything, at the low end of the range of reasonableness when compared with other large firms and other carriers such as AT&T and MCI. Indeed, if LECs were allowed to use realistic depreciation rates, such as those used by AT&T, LEC earnings would be well below any level that could be considered reasonable.

Further, the cost of capital calculations of AT&T and MCI are seriously flawed and fail to justify their claims for a sharing mechanism based on a lower rate of return, or a one-time rate adjustment. Among other errors, MCI's cost of capital expert erroneously concludes that competition has had no impact on the LECs' cost of equity and overall cost of capital. AT&T's cost of capital analysis is subject to several of the same errors as MCI's analysis.

A few parties take positions that would make it all but impossible for LECs to effectively respond to competitive entry into access markets, and which would deny consumers the benefits of full competition. These parties, including CAPs such as MFS and Teleport, state that LEC competitors have less than 1% of the market, and argue that a long-list of conditions must be satisfied before LECs can be allowed to compete fully with new market entrants. The arguments of these parties, however, fail to consider the appropriate service and geographical dimensions of access markets. Moreover, it makes no sense to compare total nationwide LEC revenues to the total, nationwide revenues of CAPs, when those providers have made clear their intent to focus on those services and geographic areas for which there is a concentration of traffic that makes competitive entry profitable. This "focus strategy" has already enabled CAPs to capture substantial portions of LEC access markets.

MFS and Teleport also argue that it is necessary to analyze the total markets served by LECs because LECs utilize common facilities to provide their services and this, they allege, permits LECs to "cross-subsidize" the prices of services facing more competition by "shifting" shared and common costs to services facing less competition. It is impossible, however, for LECs to engage in the kind of cost-shifting contemplated by MFS and Teleport. Not only does USTA's price cap proposal isolate competitive access services from other access services, a LEC's price actions regarding more competitive interstate services has no impact on, or connection to, its ability to raise rates for less competitive intrastate local exchange service.

Several parties are quick to dismiss the notion that LECs will face real competition anytime soon. If anything, however, USTA's initial comments understated the pace of change which is transforming the telecommunications industry and opening markets to competition. This change underscores the need to reject the arguments of parties, such as AT&T, which suggest that it is unnecessary for the Commission to address now the issue of how to transition regulation as markets become more competitive.

USTA believes that the failure to adopt procedures for an orderly regulatory transition to competition would be a serious mistake. No costs or risks will be incurred in affirmatively addressing the transition issue at this time. It will not pre-judge the level of competition in any market. Moreover, there are significant benefits in adopting a policy framework that will facilitate and accommodate changing technological, competitive and market conditions. In contrast, if a transition mechanism is not adopted now, the risk of not achieving an orderly transition to competition, and the potential for generating economic loss to society, are substantial.

Some parties suggest, however, that a transition policy is not necessary because, they allege, the price cap LECs already have sufficient pricing flexibility. These parties are mistaken. While the price cap baskets and bands, and zone density pricing, have provided LECs with a minimum level of pricing flexibility, this flexibility is entirely inadequate to allow for a fair, but meaningful, LEC response as competition continues to develop in access markets.

Several parties propose criteria for determining whether competition is present in access markets. Surprisingly, AT&T advocates a market share approach. AT&T has consistently maintained in proceedings concerning the competitive nature of IXC markets that market share should <u>not</u> be used to measure market power. More importantly, market share does not reflect the availability (or capacity) of alternative service providers which is an important determinant of market power.

Additionally, a market share measure excludes access supplied by IXCs and end users. Market share is also a backward-looking indicator which will send distorted and non-economic price signals to new market entrants.

Teleport proposes that the DOJ's Horizontal Merger Guidelines be used by the Commission to determine whether LECs should be allowed reduced regulation. Teleport, however, incorrectly applies the Merger Guidelines. Moreover, the measure of market concentration under the Guidelines - the so-called Herfindahl-Hirschman Index - is not a proper gauge of whether a regulated firm in a market should be granted or denied pricing flexibility.

USTA continues to believe that "addressability" is a more appropriate measure of LEC market power. Addressability is forward-looking and would help to ensure that customers receive the full benefits of competition, and that the decisions of new market entrants will be based on realistic price signals.

MFS, AT&T and MCI urge the Commission to adopt Total Service - Long Run Incremental Cost (TS-LRIC) as the basic standard for Commission review of LEC rates. These proposals are designed to prevent LECs from utilizing the most efficient price structure with which to compete and are inappropriate as a measure of the lawfulness of individual rate elements.

The ICA proposes a "price linking" approach to new services. This complex proposal goes against a fundamental feature of price cap regulation which generally allows rates to be established independently of other rates. Price-linking would also be economically inefficient, and would send incorrect price signals to both competitors and customers.

Several parties call for a higher productivity factor based on claims that LEC earnings have been excessive under price caps. First, as noted above, LEC earnings have been reasonable under price caps. More importantly, earnings, especially short-term earnings, can never be a surrogate for productivity. Earnings are based on accounting costs, not economic costs which are the appropriate costs to be included in a productivity analysis. This difference can result in a substantial disparity between earnings and true productivity especially where, as here, earnings are based on uneconomic depreciation rates. Further, a productivity adjustment based on three years' earnings results would simply recapture LEC productivity gains and would severely limit price cap incentives.

Additionally, the studies and logic supporting arguments for a higher productivity factor are flawed. For example, although it correctly views a Total Factor Productivity study as the appropriate way to determine LEC productivity, Ad Hoc errs in its calculation of that productivity. Ad Hoc also incorrectly proposes an add-on of 1% to account for an alleged "input price differential," and another 1% as an inflated and totally unsupported consumer productivity dividend.

MCI turns logic on its head in urging the Commission to base a new productivity factor on only one of the two studies underlying the original productivity factor, but without the 1984 data point. MCI compounds its error in arguing that because its "new productivity factor" is 2.6% above the productivity factor used for the past three years, LECs must reduce their price indices by 7.5%. Such an adjustment would be a particularly deleterious form of productivity recapture that would substantially dampen price cap incentives. It would also constitute unlawful retroactive ratemaking.

Although USTA has shown that the common line adjustment formula should be eliminated, a few parties argue that the Commission should switch from a 50/50 formula to a per line formula. Factors, other than LEC actions, however, are likely responsible for the downturn in demand growth which the non-LEC parties point to as justification for a per line formula. Further, there is no basis for denying a positive LEC impact on demand stimulation. LECs provide services which facilitate the completion of interstate calls. Ever lower access rates have also played a major role in increasing interstate calling, and new technologies being installed by LECs, such as SS7, will help stimulate IXC usage.

Concerning exogenous costs, AT&T fails to recognize that because the Commission has treated all equal access costs as endogenous, including those incurred after the start of price caps, the Commission cannot now treat the expiration of the amortization of equal access network configuration costs as exogenous. The Commission should also reject MCI's argument to delete tax and "other" exogenous costs from the list of exogenous costs. Further, AT&T's and MCI's proposals concerning exogenous cost treatment associated with the sale of exchanges could unnecessarily discourage transactions that would otherwise have substantial public interest benefits.

Finally, the Commission should reject TCA's proposal on service quality and infrastructure reporting. TCA's proposal would be excessively burdensome for both price cap LECs and the Commission, and is totally unnecessary given the high level of service quality under price caps and the rate of infrastructure development in rural areas of price cap LECs.

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REPLY COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association (USTA) hereby replies to the comments filed on May 9, 1994, in the above-captioned proceeding which is considering whether the price cap plan for local exchange carriers (LECs) should be revised in order to meet the Commission's public interest objectives through the end of the decade.[1]

I. INTRODUCTION

In its May 9 comments, USTA demonstrated that while the existing price cap plan has benefited consumers over the past 3 1/2 years, the plan can never reach the full potential of incentive regulation, let alone achieve the Commission's goals for the Information Age, without several fundamental changes. Specifically, the plan must -

- Be severed completely from cost-based rate of return regulation by eliminating sharing and the low-end adjustment mechanism so that LECs will have proper investment and efficiency incentives,

[1] This proceeding was initiated by a Notice of Proposed Rulemaking (NPRM), FCC 94-10, released February 16, 1994.

and so that LEC shareholders, not ratepayers, will bear the risks of operating in a more competitive industry environment.

- Decodify all access rate elements, except so-called "Public Policy" elements, which will help facilitate the introduction of new services by LECs in a timely manner.

- Afford increased LEC pricing flexibility as access markets become more competitive, and simplify the new service pricing rules and tariff processing procedures in order to ensure that consumers fully reap the benefits of competition.

- Correct the LEC productivity factor so that it is based on a long-term total factor productivity study, which is the only appropriate method for determining LEC productivity.

- Equalize the regulation of LECs and other access providers to provide for more balanced and fair competition.

In proposing a comprehensive plan for price cap and regulatory reform, USTA showed that these changes, along with other modifications, would help the Commission realize all of its goals for price caps including increased telecommunications infrastructure investment and economic growth.

Approximately 38 other parties also filed comments in this proceeding. Most of the non-LEC comments raise arguments that generally can be categorized as either ways to provide short-term benefits to certain parties at the expense of the Commission's long-term objectives, or reasons why the Commission should not adopt procedures which would permit LECs to effectively compete with other service providers as competition increases in access markets.[2] Virtually none of these parties attempt to show how their proposals will further such important public interest goals as encouraging the development of a National Information Infrastructure (NII), promoting the introduction of new services and technologies, stimulating economic growth, and promoting network efficiency. Indeed, one party, the Ad Hoc Telecommunications Users Committee (Ad Hoc), goes so far as to argue that there is no "cause and effect" relationship between the Commission's regulatory policies and telecommunications infrastructure development and economic growth,[3] suggesting that any attempt by the Commission to pursue policies intended to accomplish such objectives would be "perhaps illegal."[4]

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[2] Professor Robert Harris of the University of California - Berkeley, notes that the comments of many of these parties exhibit the "stereotypical rent-seeking behavior" of "competitors who stand so much to gain from continuing regulatory policies that limit competition and restrict the incentives and flexibility of LECs." Robert G. Harris, "Reply Report on LEC Price Cap Reforms: United States Telephone Association" (Harris Reply), pp. 19-20 (emphasis in original deleted). The Harris Reply is appended to these comments as Attachment 1.

[3] Ad Hoc Comments, pp. 6-10.

[4] Id. at 7. Ad Hoc's views contrast with those of two parties which do not have any direct economic stake in this proceeding, other than to ensure that the Commission pursues policies which would encourage meaningful infrastructure investment. See Comments of the American Library Association, p. 2; Comments of the Council of Chief State School Officers, and the National Association of Secondary School Principals, p. 3.

USTA submits that there is nothing illegal in recognizing that telecommunications is of increasing importance to society and to the national economy, and that regulatory policies can and should create incentives similar to those present in competitive markets in order to encourage the most efficient deployment of new facilities and services, and to stimulate economic growth and job creation.[5] Only by adopting USTA's proposed revisions to the LEC price cap plan can the Commission accomplish these and other important goals.[6]

The remainder of these reply comments addresses the primary arguments of the non-LEC parties. Specifically, in Section II below, USTA answers those parties who argue that the sharing mechanism should not only continue, but should be tied to a substantially lower rate of return than that utilized by the current price cap plan. In Section III, USTA rebuts the arguments of parties that would limit the LECs' ability to compete for an indefinite period of time, and shows that regardless of the extent of competition in

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[5] See NPRM, ¶ 33. Professor Harris notes that the identification of telecommunications as a strategic industry does not mean that the U.S. is practicing a form of "industrial policy" which appears to be so abhorrent to Ad Hoc. Harris Reply, p. 11. He states: "[P]recisely because the U.S. does not practice classical 'industrial policy' by expending large sums of public funds on targeted industries, it is all the more important that the Commission adopt policies that will attract sufficient private investment in strategic industries." Id.

[6] See USTA Comments, pp. 3-4.

particular access markets, it is essential for the Commission to have in place "adaptive" regulatory procedures that will permit meaningful LEC competition when warranted by objective market criteria.

In Section IV, USTA demonstrates that there are no grounds for increasing the price cap formula's productivity factor, or for adopting a per-line common line adjustment formula. Finally, in Section V, USTA refutes arguments calling for, among other things, changes in the treatment of exogenous costs under price caps, procedures that would unreasonably limit the sale and swap of telephone properties, and increased reporting requirements.[7]

II. THE SHARING MECHANISM MUST BE ELIMINATED, NOT MADE MORE ONEROUS, IF THE COMMISSION IS TO ACHIEVE ITS OBJECTIVES UNDER PRICE CAPS.

Non-LEC parties generally argue for retention of the sharing mechanism,[8] including parties which urge elimination

[7] In addition to Professor Harris' reply, the following statements are included with these comments: "Report of Dr. Randall S. Billingsley" which rebuts certain parties' estimates of LEC cost of capital (Billingsley Report), appended hereto as Attachment 2; "Reply Comments: Market Analysis and Pricing Flexibility for Interstate Access Services," by Richard Schmalensee and William Taylor (Schmalensee and Taylor Reply), appended hereto as Attachment 3; and "Economic Performance of the LEC Price Cap Plan: Reply Comments," by National Economic Research Associates, Inc. (NERA Reply), appended hereto as Attachment 4.

[8] See, e.g., Ad Hoc Comments, p. 24; Initial Comments of the International Communications Association (ICA), p. 14.

of the low-end adjustment mechanism.[9] In contrast, USTA's Comments demonstrated that sharing, the low-end adjustment mechanism and other vestiges of cost-based rate of return regulation, have no place in a price cap plan that must facilitate a regulatory transition to competition, and which has among its objectives substantial infrastructure development, economic growth stimulation, enhanced productivity, and new service introduction and technology deployment.[10] USTA will not burden the already voluminous record in this proceeding by repeating each of its arguments here. Suffice it to say, none of the parties who call for the continuation of sharing acknowledge the perverse effect sharing has on price cap incentives.[11] As the Computer & Communications Industry Association (CCIA) correctly observes, however, the price cap "system is . . . compromised to a considerable degree by the 'sharing' mechanism."[12]

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[9] See Comments of AT&T Corp. (AT&T), pp. 29-30; Comments of MCI Telecommunications Corporation (MCI), pp. 31-32.

[10] See USTA Comments, pp. 21-23, 45-52. USTA submits that sharing and the low-end adjustment mechanism are intertwined and one cannot be eliminated without the other.

[11] As USTA's comments noted (p. 9), the current LEC price cap plan provides only a little more efficiency incentives than does rate of return regulation. See "Regulatory Reform for the Information Age," Strategic Policy Research, Bethesda, MD, pp. 22-23.

[12] CCIA Comments, p. 7; see Comments of Citizens for a Sound Economy Foundation, pp. 5-6.

Several parties also argue that the sharing mechanism should be recalibrated to a lower authorized rate of return than the current 11.25% earnings level. Ad Hoc, for instance, claims that, based on lower interest costs, the "benchmark rate of return used for setting the sharing and low-end adjustment triggers should be reset downward."[13] Both AT&T and MCI take similar positions.[14] These interexchange carriers (IXCs) offer evidence that allegedly supports a lower cost of capital for local exchange carriers.[15] They argue that, based on such lower cost of capital, LECs should be required to make one-time adjustments to their price caps in addition to retargetting the sharing mechanism thresholds.[16]

At the outset, USTA submits that these arguments are irrelevant to a properly formulated LEC price cap plan. Only by eliminating the last vestiges of rate of return regulation from LEC price caps, including debates over cost

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[13] Ad Hoc Comments, p. 25; see, e.g., Comments of Aeronautical Radio, Inc. (ARINC), p. 3-4; Comments of the Office of the Consumers' Counsel, State of Ohio (OCCO), p. 9.

[14] See AT&T Comments, pp. 29-30 (The sharing "mechanisms should be further modified to account for the marked reduction in the cost of capital within the past few years."); MCI Comments, p. 29 ("To the extent the LECs' cost of capital has changed, it is necessary to adjust the sharing and low-end adjustment ranges accordingly.")

[15] See AT&T Comments, p. 31, Appendix D; MCI Comments p. 29, Appendix A.

[16] See AT&T Comments, p. 30; MCI Comments, p. 27.

of capital and earnings, can the Commission achieve the full potential of incentive regulation. In short, so long as the objectives of incentive regulation are being met, and consumers are benefiting because rates and not costs are being regulated, it should not matter what a price cap carrier earns. Indeed, one would expect that in some years some carriers would have high earnings, in some years average earnings, and in some years low earnings, just like firms in all other sectors of the economy that are not regulated on a cost basis.

While this should be a sufficient response to arguments that the price cap sharing thresholds and indices should be adjusted downward, USTA is compelled to address arguments that, in essence, ask the Commission to prescribe a new LEC rate of return. This, of course, is not a represcription proceeding and, thus, the Commission is legally precluded from prescribing a LEC rate of return here. Moreover, USTA demonstrates below that LEC earnings under price caps have been entirely reasonable. USTA also shows that both AT&T's and MCI's cost of capital computations are seriously flawed and support neither a recalibration of the sharing mechanism, a one-time adjustment of the price cap indices, nor the prescription of a new LEC-authorized rate of return.

A. No Matter Which Way You Slice It, LEC Returns Were Reasonable Under Price Caps.

In this section, USTA demonstrates that overall LEC earnings under price caps - an average of 12.34% for the 1991-93 period - were no higher than the average earnings of non-regulated firms which generally operate in highly competitive markets.[17]

Because a goal of price cap regulation is to replicate the results of competitive markets, it is appropriate to compare the earnings of the price cap carriers with the earnings of firms in such markets. This comparison can be made using the earnings results of the Standard & Poors 400 Industrials (S&P 400) for the years 1991 through 1993. During this period when price caps were in effect, the average return of the price cap LECs - 12.34% - was 258 basis points below the 14.92% average return of the S&P 400, placing the LECs in approximately the 35th percentile of the S&P 400.[18] Thus, the earnings of the price cap LECs were

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[17] In Section III below, USTA shows that many LEC markets are already competitive, and others are rapidly becoming competitive.

[18] The S&P 400 returns were calculated as Net Income Before Extraordinary Items + Interest Expenses divided by Average Invested Capital (Long Term Debt + Preferred Stock + Minority Interest + Common Equity). These returns were arrayed, market-weighted and ranked from the highest percentile (100%) to the lowest (0%). Source: Standard and Poor's "Compustat PC Plus," CD-ROM database, dated May 31, 1994.

entirely reasonable when compared to the earnings of generally competitive firms.

The comparison of LEC earnings with S&P 400 firms is even more dramatic when average LEC earnings are calculated using AT&T's depreciation rates which are comparable to those used by non-regulated firms. As noted in USTA's comments (p. 16), average LEC earnings would have been in excess of 300 basis points lower - in the 9 to 10 percent range - if LECs had used the depreciation rates used by AT&T during the price cap period.[19] Such LEC earnings would fall in approximately the 19th percentile of the S&P 400.

Average price cap LEC earnings have also been lower than both AT&T and MCI. As noted in USTA's comments (p. 16), AT&T's total interstate earnings under its price cap plan were 13.41% in 1991 (164 basis points above average LEC earnings of 11.77% that year), 12.77% in 1992 (44 basis points above the LECs' 12.33%), and 13.49% in 1993 (56 basis points higher than the 12.93% earned by the LECs).[20] Given

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[19] AT&T's composite depreciation rate is approximately 10%. The price cap LECs' prescribed composite rate is approximately 7%. There is no economic rationale for saddling LECs with substantially lower depreciation rates than that utilized by another communications carrier which is subject to the Commission's rules and which employs much of the same types of plant that is utilized by the LECs.

[20] Again, the differential between price cap LEC earnings and AT&T's earnings increases by over 300 basis points when made using comparable depreciation rates.

these results, there can be only one of two explanations for AT&T's proposal to incorporate a lower cost of capital in the LEC price cap plan: either AT&T is mistaken as to the true cost of capital, or AT&T itself does not operate in a sufficiently competitive market to ensure that the "marked reduction in the cost of capital within the past few years"[21] is flowed through to AT&T's customers.[22]

MCI's earnings results are similar. MCI's return on investment was 14.22% in 1991 (245 basis points above average LEC earnings), 13.90% in 1992 (165 basis points above the LECs) and 12.64% in 1993 (only 29 basis points lower).[23]

In sum, average LEC earnings under price caps have been much lower than the earnings of other large firms, and have generally been lower, in some years far lower, than the earnings of both AT&T and MCI during the initial price cap period. Particularly when viewed in light of the LECs' exceedingly low prescribed depreciation rates, LEC earnings levels have been, if anything, on the low side of the range of reasonableness. Moreover, LEC earnings levels are

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[21] AT&T Comments, pp. 29-30.

[22] As USTA's comments (p. 16) noted, the Commission found AT&T's earnings under price caps to be reasonable. See Price Cap Performance Review for AT&T, 8 FCC Rcd 6968, 6969 (1993).

[23] See Standard and Poor's "Compustat PC Plus," supra.

entirely consistent with one of the fundamental goals of price cap regulation which is to encourage LEC efficiency through increased earnings potential.

B. AT&T's and MCI's Cost of Capital Calculations Are Seriously Flawed.

AT&T claims that the "LECs' cost of capital has averaged no higher than 9.93 percent over the period 1991-93 . . . ."[24] Similarly, MCI argues that the "LECs' cost of capital has fallen to 9.54% . . . . "[25] As discussed below, the cost of capital calculations of both of these parties are seriously flawed and fail to justify their claims for a sharing mechanism based on a lower rate of return, or a one-time rate adjustment.

As an initial matter, this is not a represcription proceeding and, as noted above, the Commission is legally precluded from prescribing a new LEC rate of return in this proceeding. USTA notes further that no evidence presented in this proceeding is relevant to the authorized rate of return applicable to any LECs under rate of return regulation. USTA believes that rate of return is an

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[24] AT&T Comments, p. 31.

[25] MCI Comments, p. 28.

appropriate form of regulation for many smaller LECs.[26] USTA is also committed to a LEC unitary rate of return.[27]

Further, even if viewed solely as justification for a lower sharing threshold, MCI's and AT&T's arguments claiming a lower cost of capital must be rejected. As Professor Billingsley points out, MCI's cost of capital analyst, Matthew Kahal, has made several fundamental errors which vitiate his conclusion that the overall cost of capital for the LECs is 9.54%.[28] Specifically, while recognizing that LEC markets have become increasingly competitive since 1990, Kahal erroneously concludes that this competition has no impact on the LECs' cost of equity and overall cost of capital.[29] In fact, this competition, and the outlook for future competition, plays an important role in the expectations of today's investor regarding the price cap LECs.[30] Kahal also improperly relies on the Regional Bell

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[26] See USTA Comments, p. 6, n. 7. The Commission has recognized that it should provide a "continuum" of regulatory options which reflects the diversity of small and mid-size LECs. See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-134, FCC No. 93-253, released June 11, 1993, ¶ 4, 5.

[27] See Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Process, CC Docket No. 92-133, Notice of Proposed Rulemaking and Order, 7 FCC Rcd 4688, ¶ 6 (1992).

[28] See Billingsley Report, pp. 8-9.

[29] Id. at 9-10.

[30] See id. at 10.